BEFORE THE INSURANCE COMMISSIONER
OF THE STATE OF WASHINGTON

In the Matter of THE APPLICATION REGARDING THE CONVERSION AND ACQUISITION OF CONTROL OF PREMERA BLUE CROSS AND ITS AFFILIATES	No. G02-45 PRE-FILED RESPONSIVE TESTIMONY OF DONALD S. NEMEROV

I, Donald S. Nemerov, do hereby declare that the following facts are personally known to me and, if called upon to do so, I would testify to them.

Principle-based Executive Compensation

PricewaterhouseCoopers LLP (PwC) Point-of-View

1. The form and amount of executive compensation in corporate America has always received a high level of scrutiny, but never more than today. Executive compensation practices have been impacted by corporate financial scandals, a perceived lack of transparency, the absence of independent, rigorous corporate governance, excessive payments relative to company performance or to employees broadly, and costly unfunded retirement benefits for a select few executives.

2. To ensure implementation of a strategic, reasonable and performance-based executive total compensation (that is base salary, annual and long-term incentives, deferred compensation/retirement benefits) structure, certain key issues must be addressed. Specifically, is the executive total compensation structure:

a. Aligned with a company's business strategy? Are the various compensation and benefit programs periodically reviewed to ensure alignment, and changed as appropriate to accommodate normal shifts required due to competitive markets or business lifecycle?

b. Competitive as needed to attract and retain leadership talent and ensure sufficient depth or "bench strength" in management talent?

c. Primarily performance-based, emphasizing at-risk compensation (versus non-risk components such as base salary and retirement benefits or perquisites) to the extent possible without hampering the company's ability to attract and retain executives?

d. Ratified and approved by an independent compensation committee that oversees the design and administration of programs to ensure that shareholders and other key stakeholders are represented? Does the committee consider the compensation program in total and make executive pay decisions with clear knowledge of the competitiveness of the total compensation structure?

3. At the center of this scrutiny is the compensation committee. The committees challenge has been well-articulated: *"Good compensation practices directly translate into shareholder value through enhanced management and therefore improved corporate performance. That objective, of improved corporate performance, must drive the deliberations of all boards of directors."* – Report of the NACD Blue Ribbon Commission on Executive Compensation: Guidelines for Corporate Directors

4. To ensure this alignment and reasonableness, the American Bar Association in its 1997 Corporate Director's Guidebook (2nd Edition) states that *"The executive compensation debate revolves around four questions:*

Are the senior executives and the CEO being paid too much?

Is their compensation reasonable related to personal and corporate performance?

Are their post-employment benefits properly related to the overall benefit of the corporation and reasonable in amount?

Is there effective oversight of management's compensation?"

5. A few specific points of inquiry PwC undertakes in order to answer important questions related to program alignment and reasonableness include:

a. Are the performance measures used in this plan comprehensive, aligned with the company's strategy, and within the scope of executives' control?

b. Are the performance standards aligned with investors' expectations? What methods, other than budgets and operating plans, are being used to establish their validity?

c. Do the plans provide payouts across a reasonable spectrum of performance outcomes?

d. Are external benchmarks related to either compensation levels and performance standards evaluated with reference to reasonable peer groups?

e. What is the impact of the incentive plans on the company's profitability and cash flow? How much of each incremental dollar of profitability is being shared with executives?

f. Has the Compensation Committee outlined a pay-for-performance philosophy that is consistent with the corporate strategy? Does the Compensation Committee (or another Board Committee of the full Board) ensure that a meaningful process is utilized for evaluating CEO performance?

Errors in Towers Perrin Findings and Methodology

6. PwC has identified certain reporting errors that are material to PwC's review of Premera's executive compensation programs. PwC's response to each of these errors follows.

Top 5 Officer Job Matching

7. Towers Perrin (TP) continues to assert in its pre-filed direct testimony of March 31, 2004, that PwC matched executive positions based on "job title only." As has been clarified in depositions and in pre-filed direct testimony, PwC also used other materials provided by Premera in matching of Premera officer positions to survey benchmark jobs, including an organization chart (Request # WA103, Bates # 0012409) and duties and responsibilities as outlined within executive agreements.

8. PwC notes that job matching and pay benchmarking is an imprecise process. No two organizations are ever structured exactly the same, with the same duties executed by each executive across all companies. PwC emphasizes that job matching was adjusted for certain additional responsibilities executed by Messrs. Milo and Wang, which served to increase the assessed market compensation for these incumbents over their core functional expertise (i.e., legal and actuarial, respectively). PwC also emphasized that its benchmarking does not evaluate the talent or efforts of any individual Premera job incumbent, rather determines PwC's assessment of the market value of the position. Finally, PwC notes that it did not discount Premera executive responsibilities versus public companies, which could perhaps be justified on the basis that none of the Premera officers are required to perform certain responsibilities required of their counterparts within public companies, such as

Sarbanes Oxley requirements, Section 404 certification, investor relations, rigorous and frequent financial disclosure, etc.

Incentive Funding/Goal Setting

9. In TP's Supplemental report dated March 5, 2004, TP asserts that PwC has misinterpreted the mechanics regarding award determination for Premera's annual and long-term incentive plans. The report states that Premera operating income funds a bonus pool for executives that subsequently can only be reduced based on performance on strategic, non-financial measures.

10. Per Section 5. Determination and Allocation of Awards within the 2002 Premera Blue Cross Officers Annual Performance Incentive Compensation Plan (Bates# 0011761 – 0011765):

> *"Awards earned pursuant to the Plan will be based on the achievement of preestablished annual performance goals and an overall assessment of individual contribution completed by the Chief Executive Officer of Premera Blue Cross. This assessment will be applied to the Award earned and may range between a plus or minus 20% of the Award value."*

11. TP also states that the officer plan is of higher risk than most plans, in that without minimum financial performance, officers payouts cannot occur, whereas many companies maintain plans that have independent operation between financial and non-financial results (whereby payouts could occur on nonfinancial results even if financial results are below a certain threshold).

12. However, per Section 6. Payment of Awards Earned, within the 2002 Premera Blue Cross Officers Annual Performance Incentive Compensation Plan:

"The size of Awards, if any, for the Plan Year will depend upon the Company's financial performance and the Participant's achievement of the performance objectives and individual contribution as determined by the Chief Executive Officer and approved by the Committee. If minimum financial performance, as deemed by the Committee, is not attained for the Plan Year, no payment will be made to Participants except as otherwise provided by the Committee."

"After the minimum financial performance objective is achieved, financial and individual performance measures will be assessed independently. The committee at its discretion may establish a maximum incentive payment beyond which no additional Award would be made regardless of performance."

13. Similarly, Section VI. Payment of Awards Earned, within the Premera Blue Cross Long-Term Performance Incentive Plan 2002-2004 Performance Period / Bates # 0011784 – 0011789, states:

"...the Committee will determine for each Participant whether or not (and, if applicable, the extent to which) the Participant has achieved the Performance Objectives for that Performance Period and the amount, if any, of the Performance Award to which the Participant is entitled. Awards for a given Performance Period will be based upon the achievement of the Performance Objectives established for that Period. The Committee, in its sole discretion, may adjust individual performance Awards within a range of plus or minus 20% of the Award value, as recognition of an overall assessment of individual performance events that may occur."

14. Based on Premera's plan provisions, PwC can conclude that Premera's committee and Board has flexibility in making awards to officers above the level

funded by financial performance. PwC believes that TP has not accurately represented Premera's plan provisions, and the plans are not necessarily more conservative than competitive practice, as asserted by TP. As reference to competitive practice, we have summarized the measures and operation of incentive plans for Premera peer companies in Exhibit E-1 which is attached hereto and incorporated herein as if set forth verbatim. This clearly illustrates the strong reliance on financial metrics for rewarding the executive officers of other peer companies within the industry.

<u>Change-in-control (CiC) Benefits</u>

15. The current change-in-control benefits provided to Premera's officers are approximately $23M. TP's facts relative to Premera's change-in-control provisions are in error in a manner that impacts accurate benchmarking of Premera's CiC benefits to competitive practice:

16. TP stated in the March 5 report that any change to the CiC benefits for Premera executives would need to be a part of renegotiated individual executive agreements. As a result, any changes to these benefits, TP asserts, would need to be renegotiated individually with each covered officer. In fact, the executive agreements only refer to coverage as provided by CiC policy, per <u>Amendment No. 4 to Employment Agreement, Section 4:</u> *"In the event benefits are payable to Employee as provided under the Companies' Change In Control Provisions, the Base Percentage Amounts shall be determined based on the age of the Employee at the end of the applicable Benefit Continuation Period provided for in the Companies' Change In Control Provisions."* (Premera's Change in Control Provisions dated October 7, 2002 Bates # 0012632 – 0012648).

17. This is pertinent to PwC's finding that Premera's CiC benefits are above market practices. CiC benefits provided by policy are generally much more limited than benefits provided through individual contracts, and Premera CiC policy benefits correspond to that provided only via individual agreements. This also negates TP's assertion that CiC benefits would need to be renegotiated, when in fact; it appears that a policy revision approved by the Board would suffice.

Officer Turnover

18. In the March 5, 2004 report, TP asserted that Premera's officer turnover was higher than that reported in Watson Wyatt's 2003/2004 Insurance industry Compensation Planning Report. TP went on to speculate that due to this higher turnover, the greater availability of long-term incentives would help Premera better minimize officer turnover post-conversion. PwC found a number of errors and inconsistencies in TP's analysis as related to the definition of turnover, the time period for measurement and the comparison group of positions:

a. TP applied total turnover rates (voluntary and involuntary) in completing its analysis. Involuntary turnover is irrelevant to a determination of retention risk, as it is an event controlled by the company (e.g., termination for cause or poor performance), whereas voluntary turnover is an event controlled by the employee (e.g., leave for position with another company).

b. TP used a survey data time period of 2003 that is different than the time period of reported Premera officer turnover data (2000-2002). Turnover rates will vary by time period for reasons such as general economic and business conditions.

c. TP used data covering all exempt employees, which would include any reported position data from entry level administrative/professional through management. Turnover rates can vary meaningfully between executive, management and administrative positions.

19. PwC used competitive voluntary turnover data only, for management positions only, within the same time period as that which PwC received turnover data from Premera. Based on its analysis, PwC concluded that Premera has experienced voluntary officer turnover that is lower than market (i.e., higher levels of retention).

Areas of Material Disagreement with Towers Perrin Conclusions

20. PwC has identified certain areas of executive compensation analysis and findings with respect to Premera programs for which PwC disagrees with TP's conclusions.

Competitive Compensation Methodology

21. When PwC work with clients to benchmark executive compensation levels and practices, PwC typically will examine more than one group of benchmark companies. This is prudent for quality and accuracy purposes. PwC may also identify one benchmark group as the primary benchmark, where it believes that greater similarity in terms of industry, company size and business financials exist, the responsibilities of executives is more comparable, or where movement of executive of talent is more frequent and likely to occur.

22. Premera, until the conversion occurs, is a non-public organization, governed by Blue Cross/Blue Shield structural, tax and other specific guidelines that are unique to these companies. The corresponding duties, responsibilities and expertise of Premera officers will certainly be most similar to those performed by officers of other BCBS organizations. As such, PwC believes that the executive pay practices of other Blue Cross Blue Shield organizations is more relevant to a determination of

whether the officer pay at Premera pre-conversion is reasonable than are public companies or other health insurance companies.

23. Accordingly, PwC has provided this comparison distinctly and separately from the practices of other health insurers or public companies. In contrast, TP, as well as Premera's compensation consultant, Mercer, have presented benchmark compensation practices as a "blend" of BCBS and public company data (as reported by proxy disclosure). The rationale provided is that Premera has, and will continue to, recruit from public companies, and could lose executives to such companies within the health insurance industry. PwC agrees that Premera needed to be cognizant of public company practices; however, PwC thinks this represents a flawed approach to determining pre-conversion compensation reasonableness, and does not fully inform the Board and the public of significant differences between public and private company compensation practices. This approach serves to mask significant differences in practice across private and public companies.

24. In contrast, PwC provided findings relative to Premera's pre-conversion compensation competitiveness versus a specific survey group of BCBS peer companies in PwC's October 2003 report (Exhibit "S-27"). PwC found that Premera officer pay levels are above the market practices of similar BCBS companies.

Performance Measures

25. TP asserts in its March 5, 2004 report *"that operating margin is not a common or particularly informative performance measure in the health insurance industry."* TP then cited a Watson Wyatt (WW) survey regarding the prevalence of insurance company measures used for incentive plans that supported this. However, the WW study reported that expense ratio is the second most used measure within

executive incentive plans. Expense ratio, of course, is a key factor in yielding operating margin. PwC can further cite Premera's own investment banker, Goldman Sachs, which identified improvement in operating margin as a key driver of potential share price appreciation for Premera post-conversion. This is presumably due to the fact the Premera's operating margin, while improving, has been below industry norms. The investment banking firm reviewing Premera matters for the Office of Insurance Commissioner (OIC), The Blackstone Group, concurs that operating margin is one of the more critical measures used in evaluating Premera's, and did review Premera's margin as well as other key operating ratios as a part of evaluating the potential public value of Premera.

26. TP also asserts that *"using a single measure might encourage exiting low margin but value-creating businesses."* PwC has two comments: One, PwC has never proposed that Premera use only one measure, within its incentive plans. PwC recommends that Premera officers be rewarded for improving operating margin prospectively, while still managing the company on a balanced basis. This is a particularly important metric where Premera has underperformed relative to industry norms, and hence linking incentive payouts to performance improvement seems logical. Two, to manage on a balanced basis means that goals for margin improvement must be set based on the mix of business that is appropriate for Premera, and that does not produce unintended negative consequences (e.g. a too rapid increase in premiums).

<u>Long-term Incentive Plan</u>

27. Premera has maintained a long-term incentive plan (LTIP) since at least 1999. The LTIP intends to reward officers for achievement of goals set for three-year performance periods, with goals set annually, and a two year overlap in performance

periods (e.g., the 1999-2001 and the 2000-2002 LTIPs both included performance for the years 2000 and 2001). TP believes it would be unwise to establish a minimum shareholder return goal that must be met prior to triggering payments to executives under Premera's LTIP, in spite of the following observations:

a. The LTIP's current linkage to shareholders is relatively modest. Plan payouts are funded primarily by operating income (OI), and PwC agrees that OI growth generally is a good predictor of future increases in value. However, the minimum level of operating income required to trigger payouts under the Premera plans is set well below levels that would drive increases in share value. For example:

(1) For the 2002-2004 LTIP, the target cumulative operating income goal is set at [ ]MM, which is less than actual 2002 results plus projected 2003/2004 operating income of [ ]MM. The threshold operating income goal for triggering LTIP payouts is [ ]MM, which is less than actual 2000-2002 results of $78 million, or 2001-2003 projected results of [ ]MM.

Proprietary Material Redacted

(2) Similarly, funding for the 2002 annual incentive plan begins upon achievement of $15.8 MM in operating income, which is about 50% of 2001 actual operating income of $28 MM.

b. Best practice companies maintain a linkage between total shareholder return (TSR, defined as share price appreciation plus dividends paid) and long-term incentive payouts. TP's own survey of insurance company practices cites TSR as the second most frequently used measure within LTIPs. Most recently, many leading companies have established LTIPs that require TSR goals be met in order to trigger payments. (TP's citation of the Institutional Shareholder Services (ISS) not considering TSR data for companies with less than 3 years of public ownership is irrelevant to the establishment of appropriate pay-for-performance, or a discussion of compensation reasonableness. The ISS review specifically relates to shareholder approval of new share authorization requests, and its evaluation is focused on prospective share dilution.)

28. The LTIP is a meaningful executive compensation program, having delivered approximately $2.5M annually in incentive payouts to a select group of Premera executive participants. This is equivalent in value to about 167,000 stock options (based on the Black Scholes value of a $25 per share option), which equals about .6% share dilution each year. The LTIP payouts also effectively reduce operating margin by about .1% per year. Accordingly, PwC is uncomfortable with the LTIP's existing pay for performance, and the magnitude of potential long-term awards absent any realized value to shareholders. PwC supports the continuation of the LTIP, provided that appropriate and rigorous minimum goals are established for funding plan payouts.

<u>Officer Base Salary Increases</u>

29. TP has asserted that a limitation on salary increases would be overly restrictive and harmful to Premera, particularly for purposes of attracting and retaining executive talent or recognizing job promotions equitably. PwC understands this particular concern. PwC must note that it has recommended a limitation that is equal to the ascertainable market movement of salaries of Premera's peer companies. Absent any other factor, this appears reasonable and prudent for the following reasons:

a. Premera has experienced voluntary officer turnover rates that are below industry norms.

b. Base salaries are currently reasonably competitive, and drive most of Premera's other executive compensation and benefit programs.

(1) Annual incentive and long-term incentive opportunities are set as a function of base salary. For example, a $1 increase in base salary delivers an additional $[ ] in opportunity for Mr. Barlow, or, assuming a 5% raise and a base salary of $700,000, $[ ] additional compensation per year. For the EVPs a $1 increase yields an additional $[ ] in increased incentive compensation, or at an average base salary of $400,000, an additional $[ ] per executive.

Proprietary Material Redacted

(2) Defined benefit (DB) and defined contribution (DC) supplemental retirement benefits, and change in control benefits are set as a multiple of base salary. A $1 increase in base salary yields, on average, about an additional $[ ] in deferred unfunded benefits for the CEO and EVPs. At $2M in aggregate salaries, assuming a 5% increase, this yields an annual cost increase to the DC and DB supplemental executive retirement plan (SERP) programs of about $[ ] per year at a minimum for the top 5 executives.

Proprietary Material Redacted

(3) Premera maintains an unusual LTIP plan provision that calculates LTIP awards based on plan cycle ending salary (vs. more typically on the basis on salary at the time of grant date). This serves to increase the potential LTIP award by an additional 15% to 30% based on historic annual executive salary increases at Premera.

c. Finally, the post-conversion target long-term incentive opportunities provided to the CEO and EVPs (Top Five) are significantly greater than pre-conversion opportunities. The proposed target long-term incentive opportunity, excluding the proposed stock option grants, to be provided to Top Five has increased, in aggregate, by 15% (2004) to 30% (2005) from pre-conversion levels according to Premera's

Proposed Equity Plan. PwC suggests that this increase can be reasonably offset by controlling base salary growth prospectively.

Pay-for-Performance Analysis

30. Best practice compensation requires that senior officer (particularly the Top 5 executives who are often referred to as the "Proxy Five") pay-for-performance be set and evaluated on an objective basis. Objectivity is assured by comparing relative financial performance to relative pay levels across a peer group of companies. In this way, a more subjective evaluation of particular executives - based on their skills, talent, dedication, etc. –is avoided. The question answered by relative pay-for-performance analysis is very straightforward: Is the CEO and the executive team paid at levels that are commensurate with the relative financial returns of the organization, or not?

31. In its November 2003 report, TP asserted that PwC's pay-for-performance analysis was flawed or irrelevant on two primary grounds. The chief flaw, from TP's perspective, was that PwC applied an absolute level of operating income generated over a three-year period as one of the key factors in determining Premera's operating performance relative. Their argument is that PwC "penalized" Premera in comparison to larger BCBS organizations that generate greater levels of profit only due to their size, and that Premera's operating income (OI), while lower, grew faster than the BCBS peer group over the 2000-2002 time period.

32. Accordingly, PwC has reviewed Premera's growth rate versus the peer group over the 2000-2002 time period and found that, in fact, Premera's relative growth in OI ranked at the 45^{th} percentile of the peer group, which is actually lower than its relative rank on operating income generated over the time period (55^{th} percentile). PwC did not recompute Premera's relative performance rank, but if growth in OI had been

part of the "scorecard," Premera would actually have ranked lower for the 2000 – 2002 time period than PwC reported in its October 2003 report (Exhibit "S-27"). Please see Exhibit E-2 which is attached hereto and incorporated herein as if set forth verbatim.

33. A second concern raised by TP is PwC's relative pay-for-performance is flawed by PwC's benchmarking of Premera executives, particularly Mr. Milo's position. TP used a Chief Administrative Officer (CAO) benchmark position, which it felt more fairly represented Mr. Milo's duties and responsibilities than the benchmark jobs PwC utilized in its comparison. While PwC does not necessarily agree with TP benchmark job selection, to back test PwC's pay-for-performance analysis, PwC benchmarked Mr. Milo's pay to that of other CAO position within the BCBS survey group. Please see Exhibit E-3 which is attached hereto and incorporated herein as if set forth verbatim.

34. As a result, the new job match moves Mr. Milo's pay closer to competitive market levels. However, he is still paid above that which would be justified based on Premera's relative performance. His 2002 total cash compensation is now at the 65th percentile; while Premera's relative performance in 2002 was at the 38th percentile. His total direct compensation is at the 66th percentile of the BCBS group, while Premera's relative performance for the period 2000-2002 was at the 54th percentile. Please see Exhibits E-4 and E-5 which are attached hereto and incorporated herein as if set forth verbatim.

35. Finally, as an argument against PwC's relative performance analysis, TP asserted in its November 2003 report that *"most companies – including Premera – base their annual incentive plans on achievement of objectives that are relevant to their strategy, local market conditions, etc. Comparing annual performance for all*

companies on the same basis is highly unusual for annual incentive plan purposes and Towers Perrin believes that the analysis is not relevant to, nor appropriate for, an assessment of compensation levels."

36. This is a broad statement that contradicts how many consultants and Boards review company performance and make pay decisions for the senior executives. Taken literally, this means that TP believes relative performance is irrelevant in evaluating senior executive pay! Investors, the media, boards and compensation committees typically will review company results across a number of financial metrics, generally in comparison to associated goals, as well as relative performance to a peer group of companies. Relative benchmarking of performance is a critical step in the goal-setting, evaluation and pay decision processes that ensures executive pay reasonableness. Relative performance benchmarking mitigates the possibility for excessive payouts that might result from performance goals that are set inordinately low, or for example, within the insurance industry, for delivering incentive payments largely driven by underwriting cycles (up or down).

37. Based upon PwC's updated analysis, PwC can still conclude that on a relative basis, the pay versus BCBS peers for Premera's top 5 officers is higher than the relative performance of the company would have warranted for the review period.

<u>Change-in-Control Benefits</u>

38. TP has asserted in the March 5 report that the enhancement to the DB SERP benefit provided by Premera's CiC policy is in line with market practice. PwC disagrees. Typically, SERP benefits are enhanced in cases of a CiC by crediting years of services to the participant's vesting of benefits, which serves to increase the SERP benefit amount. In addition to this enhancement, Premera's policy also increases the

basis of compensation for determining the SERP benefit (which is calculated as a percent of compensation) in consideration of the severance benefit payable to Premera officers. The result of this unusual provision increases the SERP benefit payable to Premera executives by approximately $3M, based on current compensation levels and accrued SERP benefits. Please see Exhibit E-6 which is attached hereto and incorporated herein as if set forth verbatim.

Equity Incentive Plan

39. PwC generally agrees with TP's views as provided in its March 31, 2004 pre-filed direct testimony regarding Premera's post-conversion equity incentive plan, with a couple of noteworthy exceptions:

a. TP asserts that the one-year restriction period following the IPO is longer than has been required in most conversions. In fact, restriction periods have generally been six months to one-year. Within the peer group of companies PwC examined, PwC found that, for example, both WellPoint and WellChoice operated with a one-year restriction period. WellChoice's restrictions were actually more conservative, as all employees (and not only officers and directors), were restricted from receiving equity grants for a year post-IPO).

b. PwC agrees that the restriction on how many shares can be granted in any particular year is more restrictive than other Blue conversions. However, two mitigating factors should be cited: One, Premera is still maintaining its LTIP, which is unusual versus other peer BCBS companies (only 3 of 15 public Blue companies have made LTIP awards in PwC's most recent study of peer proxies Exhibit E-7). Two, year-by-year grant restrictions are becoming an increasingly common practice, as companies become more sensitive to the dilutive effect of their stock-based compensation plans.

c. PwC also agrees that the a limitation on specific share grants for Premera's Top Five officers over the 36 month period post-IPO is not common. However, PwC is observing an increasing number of shareholder groups and Compensation Committees of public companies that are reviewing and limiting the concentration of equity awards to the Top Five officers.

Assessment of Total Compensation Reasonableness

40. TP asserts in its March 31, 2004 direct testimony that Premera's executive compensation pre-conversion and post-conversion is reasonable. TP makes this conclusion on the basis of its evaluation of total direct compensation competitiveness (base salary plus annual and long-term incentives) and the proposed equity incentive plan. However, TP has not considered or cited other core elements of Premera's executive compensation program that delivers significant value to its officers – the DB and DC SERPs, and the CiC benefits.

41. PwC's view is that the DB and DC SERPs, while not unreasonable (in terms of their post-retirement value as a percent of each officer's compensation), represent a large unfunded liability. The project aggregate value of these programs (assuming each officer works until age 65) equals approximately $46M. Please see Exhibit E-8 which is attached hereto and incorporated herein as if set forth verbatim.

42. As summarized in PwC's October report (Exhibit "S-27"), the CiC benefits provided to Premera's executives are high when compared to other non-public companies who cover such benefits via a policy (vs. an individual agreement). The

current value of these benefits is approximately $23M for 14 officers (or approximately 3% of projected IPO market cap, which is high relative to market benchmarks).

43. The value of each of these programs for each participating officer exceeds that which each will receive prospectively via stock grants from the equity incentive plan. The OIC should consider whether the current and future costs of these programs will have a significant impact on the company's future earnings growth, operating margin, and ultimately, share value. If so, steps should be taken to mitigate a prospective increase to these benefits (i.e., absent suspending the programs to current levels, limiting salary growth would help mitigate associated future increase in cost).

Alignment with Stakeholders

44. TP has asserted that the following PwC recommendations, as provided in its February 27, 2004 Report (Exhibit "S-29"), are *"not in the best interests of the Company from the viewpoints of policyholders, shareholders, healthcare providers, future shareholders, and other constituents."* *PwC* can briefly summarize its recommendations as set forth in its February 27, 2004 report:

a. Strengthen the existing pay-for-performance programs to ensure a minimum return to shareholders prior to awarding long-term incentive payouts to Premera officers.

b. Establish salary growth guidelines that facilitate a shift in a total compensation structure currently heavily weighted to relatively low-risk annual and long-term incentive plans, and significant unfunded executive retirement plans, to more performance-based pay.

c. Establish performance measures and goals for Premera officers that are clearly aligned with shareholder return and improved operating margin.

d. Moderate, where practical, above market and significant change-in-control benefits that can be triggered one year post-conversion, without a corresponding delivery of shareholder return.

45. PwC believes that recommendations such as these would be in the best interests of the company and the enumerated constituents.

PwC Summary Conclusions

46. Overall, the changes Premera has agreed to and filed in the Form A as of February 5, 2004, represent significant and positive progress towards executive compensation programs that are more aligned to the interests of shareholders and address many of the concerns raised by PwC and other members of the Washington and Alaska consultant teams.

a. PwC believes many of the executive compensation issues identified in PwC's reports to the OIC and subsequently directly to Premera related to Premera's Form A, Exhibit G-10 filing, and Equity Incentive Plan have been addressed by Premera and now fall within the range of market standards.

b. While Premera has provided "Compensation Assurances", Exhibit E-8 to the changes to the Form A filed by Premera on February 5, 2004, PwC believes that certain important issues require further consideration. The following items remain a concern to PwC:

(1) Long-Term Incentive Plan (LTIP) – PwC believes that the current program design and governance needs to be strengthened to reflect Premera's conversion to a public company and to meet the high standards required of public companies for transparent pay-for-performance. PwC believes that a continued reliance on the LTIP as designed and administered will impair the positive motivational effects

of future equity incentives, and potentially be dilutive to share value. Given that officers are restricted from receiving share grants in the first year post-conversion, an alternative and direct linkage of the officers to shareholders would be beneficial. A minimum return requirement provides such an appropriate linkage, and assures that the costs of the LTIP are aligned with shareholders, and any potential dilution in share value.

(2) Officer base salary growth – Premera has relied on above market salary growth and unfunded, no risk deferred compensation and executive retirement program to attract and retain its current officer team. Pre-conversion, this may have been a prudent compensation strategy for attracting executive talent needed to grow the business and profitability. Post-conversion, PwC suggests that reliance on these programs is not necessary or appropriate. Absent suspension of these deferred programs (a drastic action) a reasonable mitigating action is to limit base salary growth, (which as noted triggers increases to these liabilities). A limitation on base salary prospectively would facilitate an increase over time of the portion of executive total compensation that would be delivered in the form of performance-based pay and equity incentives. PwC notes that voluntary officer turnover at Premera is below industry norms; hence PwC does not expect officer retention risk to arise from this recommendation.

(3) Selected Premera change-in-control policy provisions – Premera has maintained CiC benefits comparable to or in certain cases, above those provided to executives in public companies. The level of benefits is such that near term, the covered officers stand to realize CiC benefits that are well in excess of the value of their proposed equity incentives. PwC suggests that the OIC consider the possible impact

this would have on the viability of the proposed conversion and what, if any, modifications to current CiC benefits could occur that would not cause a lack of reasonable protection for officers covered by the current CiC policy.

47. Finally, PwC acknowledges the benefits of oversight of an independent and diligent Compensation Committee, but also notes that there are real limitations to the process. These limitations can be mitigated through plan provisions that provide explicit "checks-and-balances." In this particular instance, during a period of time post-conversion and high public scrutiny it may be prudent for certain "normal" committee judgments to be strengthened by OIC guidance as recommended here.

I declare under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

Dated April 14, 2004 at Chicago, Illinois.

DONALD S. NEMEROV

PricewaterhouseCoopers

Premera Executive Compensation Review:

Premera Exhibits for Pre-Filed Responsive Testimony

April 2004

Annual Incentive Plan Peer Provisions & Metrics

Company	Annual Performance Measures
American Medical Security Group	The corporate performance factors under the Executive AIP are EBITDA and revenue.
AMERIGROUP	Corporate performance goals: total premium revenue, earnings per share, administrative & health benefit expense ratios. Bonuses are only paid if both corporate and individual performance goals are achieved.
Anthem	Performance goals are based on a comparison of corporate-wide, business unit and workgroup performance in relation to a number of business criteria including, but not limited to, the following: net income, operating gain, business unit operating gain, and workgroup goals.
Cobalt	The Profit Sharing Plan provides executives & employees; bonuses based on: corporate profitability, individual business unit or regional area profitability and the attainment of high levels of customer satisfaction, all measured against targets set at the beginning of the year.
Coventry Health Care	Awards were based on meeting an earnings per share goal of $1.65 per share, on achievement of budgeted plan contribution and revenue by operating units and the attainment of critical success factors developed by key executives.
First Health Group	The cash bonus plan for senior management is tied to growth of earnings per share.
Health Management Associates	A bonus (% of base salary) may be paid to participants each year in which the company achieves at least 75% of its profit plan.
Mid-Atlantic Medical Services	Bonus compensation is based on achieving a predetermined pretax income goal.
Sierra Health Services	Annual incentive bonuses are payable based on achievement of a targeted level of earnings per share, with additional and varying performance measures specified for each executive officer. Achievement of the targeted earnings level was necessary in order to fund the bonus pool, from which annual incentive bonuses would be paid out.
Triad Hospitals	Bonus awards for corporate office employees are contingent upon the attainment of the company's budgeted earnings per share.
Universal health Services	Annual performance targets are based upon an increase in net income from the preceding calendar year and/or return on capital.
WellChoice	Annual performance goals focused on membership growth in commercial managed care membership, pre-tax earnings and customer satisfaction.
WellPoint Health Networks	Performance measures under the annual incentive plan are earnings per share growth and shareholder value growth.

Data compiled, where reported, from proxy filings of 15 public health insurance/managed care companies (see page E-7 for listing).

Operating Income & Growth Rate

Growth in Operating Income

Peer Organization	1999-2001 CAGR%	2000-2002 CAGR%
Blue Cross & Blue Shield of AL	323%	53%
Blue Cross & Blue Shield of MA	32%	9%
Blue Cross & Blue Shield of MN	n/a	38%
Blue Cross & Blue Shield of NC	n/a	5%
Blue Cross & Blue Shield of RI	8%	-36%
Blue Cross & Blue Shield of VT	62%	13%
Blue Cross&Blue Shield of K C	391%	129%
BlueCross BlueShield of TN	-2%	27%
CareFirst of Maryland Inc	-14%	-23%
Independence Blue Cross	100%	-7%
Peer Group 25th Percentile	6%	-4%
Peer Group Average	112%	21%
Peer Group 50th Percentile	47%	11%
Peer Group 75th Percentile	156%	35%
Premera Blue Cross	6%	9%
% Rank	**25%**	**45%**

Data Source: AM Best Key Rate Filing Database; Regulatory filings

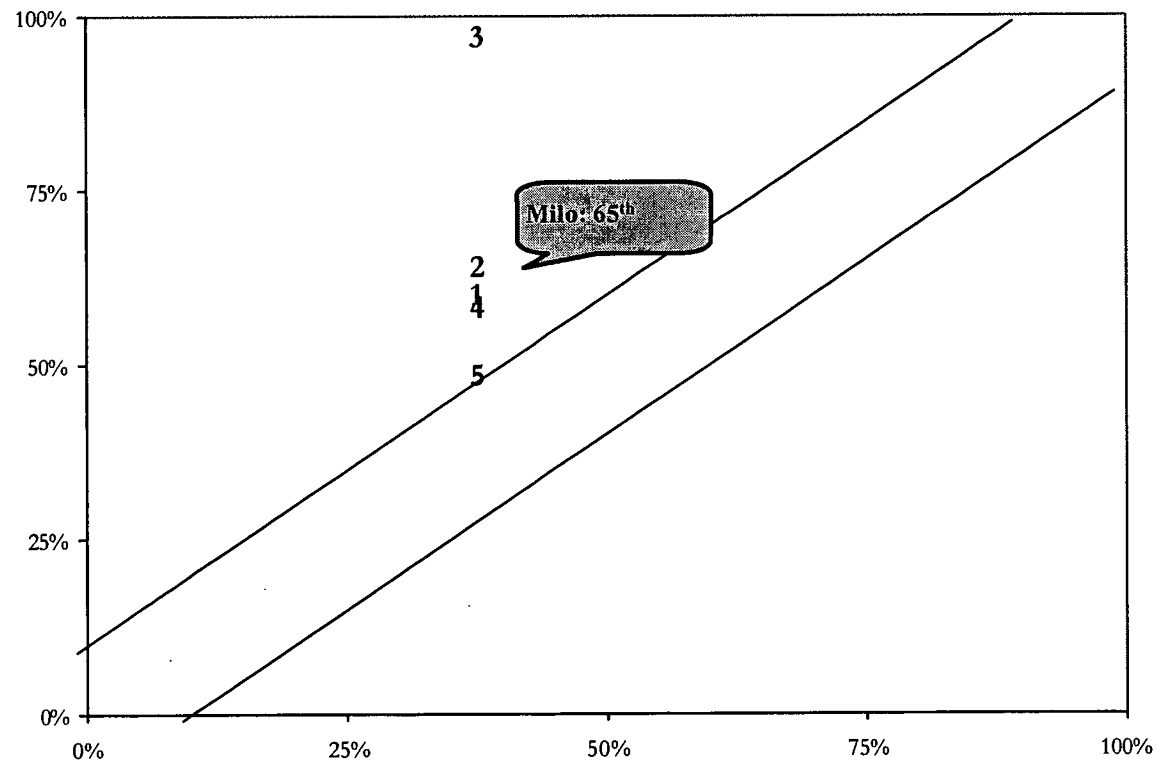
Competitive Compensation Benchmark - Milo

		Competitive Practice				Differential			
		Health Insurance Industry		Blue Cross Blue Shield		Health Insurance Industry		Blue Cross Blue Shield	
Compensation Element	Current Compensation	50th	75th	50th	75th	50th	75th	50th	75th
TCC	$567,648	$449,000	$562,000	$437,000	$626,000	26%	1%	30%	-9%
TDC	$805,295	$619,000	$923,000	$614,000	$960,000	30%	-13%	31%	-16%

Mr. Milo's position is benchmarked to a Chief Administrative Officer.

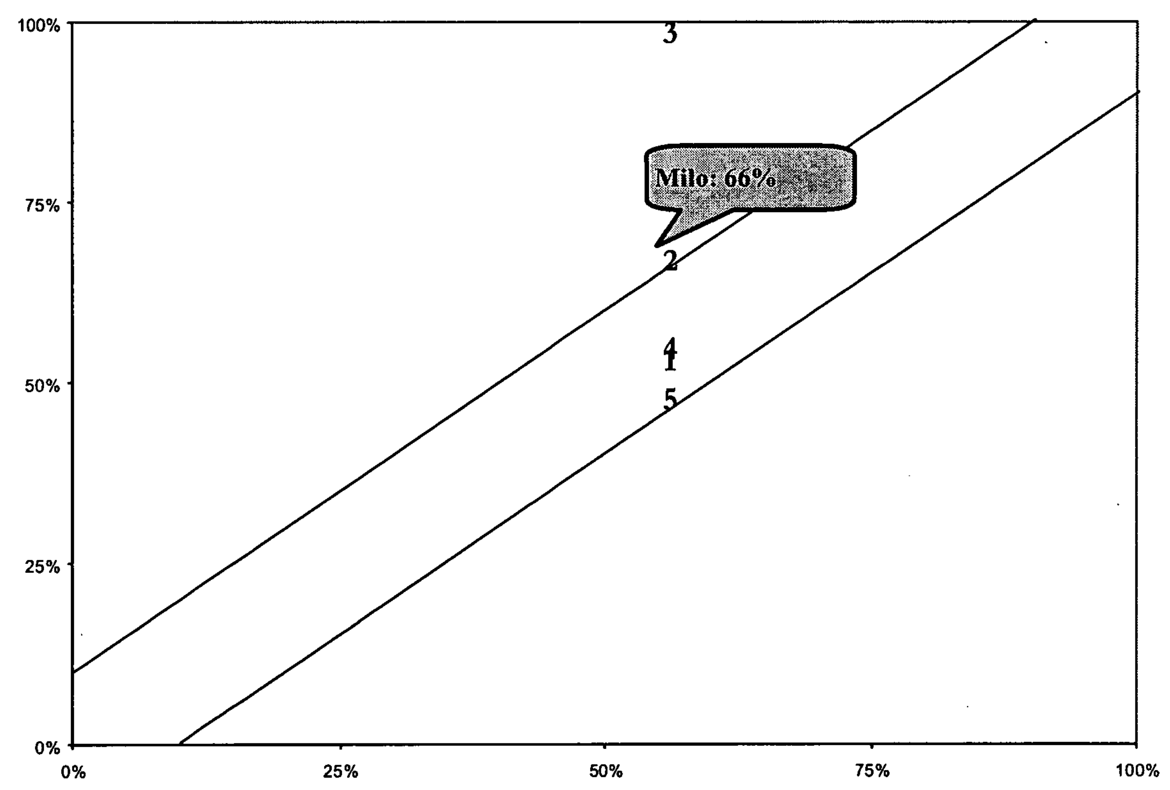
Pay-for-Performance Analysis

- 2002 Relative Operating Performance vs. Officer Total Cash Compensation -



Pay-for-Performance Analysis

- 2000-2002 Operating Performance vs. Total Direct Compensation -



Impact of SERP Enhancement on CIC Benefits

Name	Attained Age as of 01/01/2004	Credited Service as of 01/01/2004	Estimated 01/01/2004 Qualified Single Sum Benefit	Change in Control: 01/01/2004 DB Serp Single Sum prior to CIC	Change in Control: 01/01/2004 DB Serp Single Sum after CIC	Change in Control: Dollar Increase (K)	Change in Control: Percentage Increase (L)
(A)	(B)	(C)	(D)	(I)	(J)	= (J) - (I)	= (K) / (I)
G. Barlow	53	6.79					
Y. Milo	53	7.67					
A. Wang	62	6.66					
B. Ancell	38	7.21					
K. Marquardt	52	5.14			Proprietary Material Redacted		
K. Bartlett	53	4.78					
J. Castigilia	50	4.60					
J. Domeika	42	6.08					
A. Halvorson	43	3.42					
J. McRae	57	9.09					
S. Sagadevan	57	5.12					
A. Smit	51	6.58					

Prevalence of Long-Term Incentives Used in Compensation Programs

Long-Term Incentive Program	Number of Companies	Percentage
Stock Options Only	7	47%
Restricted Stock Only	1	7%
Long-Term Bonus Only	1	7%
Stock Options & Restricted Stock	2	13%
Stock Options & Long-Term Bonus	2	13%
Stock Options, Restricted Stock & Long-Term Bonus	1	7%
None	1	7%
Total	15	100%

Data compiled from proxy filings of 15 public health insurance/managed care companies: American Medical Security Group, AMERIGROUP, Anthem, Centene, Cobalt, Coventry Health Care, First Health Group, Health Management Associates, Mid-Atlantic Medical Services, Oxford Health Plans, Sierra Health Services, Triad Hospitals, Universal Health Services, WellChoice, WellPoint Health Networks

Projected DB and DC SERP Lump Sum Balances

				Age 65 DB Replacement Ratios				Age 65 DC Replacement Ratios			Age 65 Total Replacement Ratios		
Name	Attained Age as of 01/01/2004	Credited Service as of 01/01/2004	Estimated 01/01/2004 Qualified Single Sum Benefit	Age 64 Total Pay	Gross DB Serp Single Sum Benefit at Age 65	Gross DB Serp Annual Annuity At Age 65	Replacement Ratio (H)	Gross DC Serp Single Sum Benefit at Age 65	Gross DC Serp Annual Annuity At Age 65	Replacement Ratio (L)	Gross Total Serp Single Sum Benefit at Age 65	Gross Total Serp Annual Annuity At Age 65	Total Replacement Ratio (P)
(A)	(B)	(C)	(D)	(E)	(F)	(G)	= (G) / (E)	(J)	(K)	= (K) / (I)	(N)	(O)	= (O) / (M)
G. Barlow	53	6.79											
Y. Milo	53	7.67											
A. Wang	62	6.66											
B. Ancell	38	7.21											
K. Marquardt	52	5.14											
K. Bartlett	53	4.78											
J. Castigilia	50	4.60											
J. Domeika	42	6.08											
A. Halvorson	43	3.42											
J. McRae	57	9.09											
S. Sagadevan	57	5.12											
A. Smit	51	6.58											

Proprietary Material Redacted